Ep #361: Rob Swanson - The Eight Rules of Investing (Part 2)

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Dr. David Phelps

Dentist Freedom Blueprint with Dr. David Phelps

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Welcome to the Dentist Freedom Blueprint, a podcast about freedom—freedom from expectations of society and the traditional path to success that has been ingrained in us from our early years, I'm joined by mavericks, renegades, and non-conformers to discuss an anti-traditional path to financial freedom, freedom of time, relationships, health, and ultimately freedom of purpose. My name is Dr. David Phelps. Let's get started.

David Phelps: Hi, it's David here, back with week number two, with a conversation with my good friend, Mr. Rob Swanson on his eight rules of investing. Last week, we covered rules number one, two and three. This week, we'll continue with four through eight. If you missed last week, you're going to want to go back and catch it, because this was a great conversation. I know you'll enjoy it.

Rob Swanson: Yeah, I know and that's exactly right. That's great. So simple system scale. The four thing, David, that I talk about is margin. I will tell people this, newer entrepreneurs or people looking at investments, I will tell them to understand the margin of the business before they decide to do it. I'm going to give you a perfect example. Years ago, I used to flip domains and I would buy and sell domains. And so I'd buy a domain for eight bucks. I'd put a little website around it and then I'd go flip it for a couple hundred bucks, a couple thousand bucks, or something like that. And the same thing with flipping real estate. So I flip real estate. Well, with real estate, I take the same 10 bucks and I put a contract in place. And I can now sell that contract for several thousand dollars, or even tens of thousands of dollars, because the margin, the value inside of that margin, is so much greater.Same effort, same knowledge, same strategy, different asset.

And so when I look at assets, or investments, or businesses, that fourth thing, margin, is the thing that I'm looking for, number one, because it has to be able to make enough money that the effort and time that I put into it is going to pay me back handsomely. And I need the margin in order to hire the team to build the scale. And so margin is that number four thing, which kind of marries into the next piece, which is cashflow. So simple system scale is kind of the business velocity. Margin and cashflow are the financial model components to my decision making. So I want high margin and I want it to lead to cashflow. If it doesn't lead to something that is a recurring income stream, I'm not interested in it.

So along this way, any of these check marks that don't get ticked off if I'm looking at a certain thing, it's a hard stop and say, "Is there a reason for me to continue? Do I need to continue?" And the answer is probably no. I'm not as much of a black and white person. I'm okay living in some gray area. So if I get down through a simple system scale margin, cashflow, and one of those is unchecked in my first look, I might ask the question, how big of an impact is that on the overall success of the operation? And it leads me into then evaluating the next three.

David Phelps: So let me stop you. That's really good. So what you're saying is on a scale of one to five, you don't have to have the first five that you just listed, all five. So there could be some redeeming factors in your evaluation, say, "Well, whichever one may not be quite there, but there's some others that redeem that to let me go forward with it."

Another question I have for you on cashflow, Rob, do you have a certain sense, or is there a metric that you would use in terms of when, how soon after your investment in the investment opportunity do you want to see that recurring cashflow start to build? I mean, should that be relatively soon? Out of the gate? Should that be within a certain period? Or does it depend?

Rob Swanson: Well, it depends a little bit. This gets, to me, into the difference in my mind between investing and speculating. If I'm going to make a "investment" and the value of my investment is on a balance sheet, or in a number of shares, or membership interest owned, or in this project that's going to come to fruition in the future, I kind of look at that as a little bit more of a speculative play, because the cashflow comes in the future. When I think of investing, I want cashflow to happen as quickly, as immediately as I can get that immediate cashflow to happen. I buy distressed real estate. It takes 30 days, 60 days, 90 days to fix it up and get cashflow.

So there's a little bit of a delay, but the effort is directly geared towards turning that investment of capital into a cashflowing stream, where sometimes that speculative play is a little bit further downfield. And you're not exactly sure when the timing is actually going to trigger, which brings me to the next thing, which is risk. And you can always circle me back if I didn't answer that question to your satisfaction, because I do think about this stuff a lot. But I'm looking for cashflow quick or I consider it speculation. And I think there's a place in everybody's portfolio for both. There are things that I do where I will defer the cashflow for the speculative upside, because I have the capital, and the income, and the ability to do that. If I didn't have the ability to do it, I'd be focusing on cashflow much, much more aggressively and much earlier.

David Phelps: No. That's no perfect. That's where I was going to go. And you just answered my full question, so that's perfect. Thank you.

Rob Swanson: Awesome. Awesome. Well, the next thing, number six, is risk. I learned this a long time ago. And I learned that in evaluating risk, the secret to evaluating risk, in my opinion, is adequately answering this question, what is my worst day? And am I okay with it? What is my worst day? And am I okay with it? And I don't think a lot of people are very good at asking that question. I think sometimes they don't really know how to put a mathematical analysis to risk and they have a hard time figuring out, what does risk mean? And if I can go all the way to the worst case scenario, the worst day, and then I can back that up to, "Okay, how do I mitigate that from happening," then I can say, "Okay, what would the second worst scenario be? Okay, how do I mitigate that from happening?" People have to be willing to ask the really hard question.

So I've been on both sides of this table, the guy raising capital. Back in 2008, I put a large real estate fund together as the financial markets and the banking industry was collapsing and things were in free fall. And I put a large real estate fund together to acquire distressed assets in the crash, real estate assets, and buy and sell. And the thing that I got good at doing was saying this, "David, let me talk to you about what I believe is probably the elephant in the room." I would say that. And I would say, "David, you're more interested in understanding how you're going to get a return of your capital than you are a return on your capital." Am I right?

David Phelps: Right.

Rob Swanson: Absolutely. You want to know, how am I going to lose, first. So when I would sit down to raise capital, that was the first thing that I would say out of my mouth. I would just pull the elephant out of the room. And I would say, "I understand that you're evaluating this opportunity and me based on risk, and based on losing everything." And I said, "So what I'd like to do, if this is okay with you, is I would like to take our conversation over the next 30 or so minutes and talk about what that worst case scenario is and all of the things that we are going to do, or have already done, to mitigate that risk. Does that sound like a fair conversation?"

David Phelps: Yeah, that's perfect. And, Rob, wouldn't you also say that the ability for one to evaluate risk or for someone to understand if you're explaining the risk factors, the elephant in the room to me comes back to your number one premise of simplicity versus complexity. The more complex something is, if I don't have experience there and I'm looking at it, well, then how do I ask myself that question, what's the worst day? Well, I have no clue. It's too complex. I don't know. I don't understand it. But if it's simple enough that either I can understand or you can help me understand it, then I'll be able to answer the question. So I think that's perfect. Yep.

Rob Swanson: Yeah. And let me do just a little sidebar here on that exact scenario. I like investing in cryptocurrency. I like investing in blockchain technology. I like investing in things that are where the world is going, maybe not where the world is.

Now, these are more speculative investments. However, when I first started that process, they were not simple to me. And my evaluation of risk was it's high risk, because it wasn't simple and I didn't fully understand all of the mechanics behind it. As I pursued knowledge and my knowledge went up, my simple understanding of, okay, that's what's going on here, my knowledge increased, cryptocurrency, blockchain became more simple in my mind, because I began to understand it. And therefore, my risk went down in my evaluation process as my knowledge went up.

When I've sat on the other side of that table and been the guy that is being solicited for capital, it kind of always boggles my mind when I'll be presented something and I'll give them that hard question, "So what's my worst day?" And when they don't just flat tell me, "You could lose everything and here's how you could lose it," and yada, yada, yada, I sit back and I say, "Okay, that's a risk evaluation, because that particular person doesn't understand what it's like to sit on this side of the table." And so risk is one of those things.

I bought the company FreedomSoft. And when I bought FreedomSoft, now, this was six years ago, but when I bought it, I was already known in the industry. And this company, FreedomSoft, the brand was known in the industry. And so one of my risk evaluating elements was if I buy this company that's known and I'm known in the same industry and I screw it up, I just go run this thing into the ground, and I just do something stupid, or whatever happens, I evaluated a personal position in the industry, risk. What would you call that? Just, I didn't want to fail in front of the industry. And so I evaluated that risk.

David Phelps: Yeah. It's financial risk, for sure, if something runs into the ground, or just market conditions don't allow you to make the best of it. Also, there's reputational risk. You are well known in the industry, right?

Rob Swanson: Yeah. Yeah. That was the word I was looking for there, a second ago, reputational risk, because I could figure out the financial risk side of it. Okay, I could lose all my money. But the reputational risk, if I lost all my money and ran it into the ground and failed and then the reputational risk, okay, what's my worst day there? How would I regain that and maintain relevance? And at the end of the day, I evaluated that I was comfortable enough with the business. I was comfortable enough with my knowledge of the business. I was comfortable enough with the simple system scale margin cashflow analysis of the business, that I was willing to take the financial and reputational risk of me screwing it all up, which was a fun thing to be, a fun place to be when you can start to evaluate investments from a lens that says, "Okay, it just kind of builds on itself."

The seventh thing on my list then, David, is headache factor. And that one's pretty self explanatory. But I also don't think that everybody does a good job of evaluating headache factor. And headache factor is how much of a pain in the butt is this really going to be? Passive income, everybody wants passive income. Well, guess what? Passive income still requires somebody to manage the manager, somebody to manage the financial books, somebody to manage the tax return. There's management that still happens. And depending on how much of a limited or general partner you might be in a particular investment asset, there are different levels of that headache factor and management that you have to step up to. And they always happen at the most inopportune times.

Right when you are about to go on vacation and something happens. And now, you're driving to the airport, getting through security, sitting to board your plane, and you're dealing with something that you don't want to be dealing with. So what I've tried to learn to do is evaluate, what are those headache factors? And how are they going to impact me? And if it's simple with a system built around it, can I make that headache factor go away through the system? Can somebody else, who, not how, can somebody else take care of that headache factor for me? So there might be the risk of headache factor. But if I can build a system around it that somebody else can deal with the headache factor as part of their job, now, my evaluation of the headache factor potential gets a green check, even though there are things that certainly could go wrong.

David Phelps: Yeah. No. That's very well said. And you're right. I think not enough people put enough time into that headache factor. Either they don't see what may be there in terms of headache factor, which as you said, there's always going to be some. But how can you set the systems and protocols to have somebody else deal with it? Is there automation or people involved with automation to solve those so it's not on you? That's beautiful.

Rob Swanson: Yep. And finally is lifestyle. And that doesn't necessarily mean that it has to be a "lifestyle" business, but what it means is, does this investment or does this business improve my lifestyle? Does it improve my financial situation? Does it improve my relational situation? Does it improve my business situation? Does it improve my lifestyle in a meaningful way? Or doesn't it? Or does it keep me neutral? Or does it detract from my lifestyle? And there have been opportunities that I have gotten all the way down on and the evaluation of risk, headache factor and lifestyle, I just said, "You know what? Even though I could see this at scale, even though I could see that there's margin, and even though it produces cashflow, the lifestyle component of it got the red X." And I said, "You know what? This isn't something that I want to pursue."

And so the reason I personally like these eight and... It's funny how you sometimes build principles and over the years, they'll evolve. I have my original Evernote, when I originally sat down and I was trying to evaluate an opportunity. And I wrote these eight things down as I was saying, "Okay, what's important to me and how should I evaluate this?" And that was in 2012. So nine years ago, I wrote these eight things down. And they still hold as true today as they did that long ago. And I haven't added or subtracted to the eight. They're the original eight. I think about other things as well, certainly, but these are the eight that I go back to on a consistent basis.

David Phelps: Well, that's why I wanted to have this topic discussed today, because I'm with you. Principles, you may adjust them, evolve them and you may package them differently, but principles typically, to your point, they hold ground for your life. They're your core values. They're the fundamental philosophy. They're the non-negotiables. In other words, what will I actually not sacrifice? And same thing. You look at these eight principles and go, "What will

I not sacrifice?" Well, there they are, right there. If I have to sacrifice any one of these, then I'm not doing it. If the sacrifice is too great and there's not other redeeming factors that will allow me to mitigate that sacrifice, then I'm not doing it. And boy, if more people would live their lives with principles that they evolve, build, do it with their significant other, I think people would have a lot better lives. But this is, again, not things that we're brought up with.

Either someone teaches this to you, or you read about it, or it evolves on your own, because you're just thinking differently and you want to live a different life than other people. And I think that's kind of what entrepreneurs are anyway. But the principles, Rob, are what I was after today and I think you nailed those. I love those. And they've stood the test of time for you. And I know, because I know you, that they work for you. And that's the key. I know enough about your lifestyle to know that this has fit and you've worked this very, very well. So congratulations to you. And thank you for sharing these with us. I think our audience, no matter what they're doing, what they're investing in, business, other investments, having a set of principles that they can utilize, or modify for their own selves, this is a good place to start.

Rob Swanson: Absolutely. Love it. Happy to share, man. It's been fun. Every time I come on and we chat, it's enjoyable. We talk about different things. And I did a little bit more of the talking this time than some of our other cases, but you said, "Hey, I want you to come in and talk about these things." And man, I'm happy to do it and really appreciate it.

David Phelps: Well, you know what? These conversations serve me just as well as it serves our audience. That's why I like to do them. And I'm privileged to have these conversations. We'll do more, because like I said, every time we do one, we go a little bit deeper in something. And I pull out some ahas. I take notes like everybody else, Rob. I'm always learning from the best. And you're definitely one of those. Thank you, sir.

Rob Swanson: Absolutely.

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